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R 290938Z SEP 06
FM AMEMBASSY KUALA LUMPUR
TO RUEHC/SECSTATE WASHDC 7632
INFO RUEATRS/DEPT OF TREASURY WASHDC
RUCPDOC/USDOC WASHDC
RUEHGV/USMISSION GENEVA 1428
RUCNASE/ASEAN MEMBER COLLECTIVE

UNCLAS SECTION 01 OF 03 KUALA LUMPUR 001832

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E.O. 12958: N/A
TAGS: ECON EFIN EPET EINV MY
SUBJECT: THE 2007 BUDGET: LET THE GOOD TIMES ROLL FOR NOW

REF: Kuala Lumpur 003906

¶1. Summary: Savoring the blessings of higher oil prices, Prime Minister Abdullah announced his first expansionary budget after two years of fiscal tightening. Higher public spending is expected to fuel domestic demand and provide a jumpstart for the Ninth Malaysian Plan. The 2007 budget builds on initiatives in the two previous budgets designed to enhance Malaysia's long-term competitiveness. The government hopes to improve public service delivery, increase the development of human capital, and address socioeconomic imbalances. It also offers targeted assistance for favored sectors such as biotechnology, information technology, communications, agriculture and Islamic finance. Business received a pleasant surprise in the form of a reduction in the corporate tax rate from 28% to 27% in 2007, and to 26% in 2008. However, despite tax cuts and higher expenditures, the budget deficit will remain comfortable at 3.4% of GDP thanks to the windfall revenue from higher oil prices. The government remains optimistic that the economy will grow 5.8% in 2006 and 6.0% in 2007. But there are clouds on the horizon in the form of softening oil prices and a weakening global economy that may have government forecasters reaching for their umbrellas.
End Summary.

Higher Fiscal Spending to Fuel Growth

¶2. Prime Minister (and Finance Minister) Abdullah presented Malaysia's 2007 budget to Parliament on September 1. Total budget expenditures for 2007 are RM 157.5 billion ($42.6 billion), up 11.6% from RM 141.2 billion ($38.2 billion) in 2006. The budget aims to sustain Malaysia's economic growth through higher fiscal spending, which is expected to boost domestic demand. More importantly, the budget provides for a substantial 24.3% increase in development expenditure to RM 44.5 billion ($12 billion) to jump start the Ninth Malaysian Plan (9MP). (Comment: The allocation for development was higher than expected. Some outside analysts believe the government is concerned about sustaining growth in a weakening external economic environment. Others perceive a political motivation, citing the importance to Abdullah's administration of a making a fast start to 9MP.)

¶3. The budget also calls for an increase in operating expenditures, but by a slower rate of 7.2%. Operating costs will grow to RM 113 billion ($30.5 billion) in 2007. Subsidies alone constitute 10.5% ($3.2 billion) of operating expenditures. In 2006, about three quarters of the total subsidy payment of $3.05 billion was spent on fuel subsidies, despite an RM0.30 ($0.08) per liter hike in the

price of gasoline in early 2006.

Fiscal Deficit Under Control

¶4. Despite the increase in public spending, the government expects the fiscal deficit to remain under control at RM 20.2 billion ($5.4 billion) or 3.4% of GDP in 2007. This compares to an estimated RM 19.3 billion ($5.2 billion) or 3.5% of GDP in 2006. The main reason is windfall revenues from higher oil prices. The government projects revenue to increase 11.8% to RM 134.8 billion ($36.4 billion) in 2007 from RM 120.6 billion ($32.6 billion) in 2006, based on an assumption that oil prices will average $70 per barrel in both 2006 and 2007. On this basis, oil-related revenues would contribute $14.4 billion or 39.9% of total revenue in 2007, up from $12.2 billion or 37.3% of total revenue in 2006. (Comment: As the petroleum income tax collection is based on preceding year's income, the government can be relatively confident of its oil revenue in ¶2007. National oil company Petronas' dividend payment to the government will balloon to $4.3 billion in 2006 from $2.9 billion in ¶2005. The dividend alone is sufficient to cover the cost of the fuel subsidies the government provides to Malaysian consumers.) Private analysts estimate that every $1 per barrel increase in crude oil prices would increase government revenue by RM 500 million ($ 135 million) over two years.

Optimistic Growth Forecast

¶5. The Treasury projects 5.8% real growth in GDP in 2006 and 6.0% growth in 2007. Although this represents a downward revision in the government's growth forecast for 2006, some private analysts think it is optimistic. In September, the Asian Development Bank (ADB) lowered its forecast for Malaysia, from 5.5% to 5.2% in 2006 and

from 5.8% to 5.0% in 2007. In making the change the ADB cited expectations of slowing growth in the U.S. economy and softening world demand for IT products. In July, the Malaysian Institute of Economic Research (MIER) forecast that the Malaysian economy would grow 5.2% in 2006 and 4.8% in 2007. Finance Minister II Mohamed Nor Yakcop insisted that the government's growth targets could be achieved as its forecasters had already factored in the chances of a weakening external environment. Most local private forecasters are projecting growth of around 5.6% at most in 2006, but there are a few who share the government's view that real GDP growth could hit 6% next year.

The Budget Goals

¶6. The 2007 budget is the first to address the implementation of the Ninth Malaysian Plan (9MP), the government's 5-year development plan. Like its predecessors, it also aims to support Malaysia's national objective of achieving developed country status by 2020. The budget features five key "thrusts":
-- Moving the economy up the value chain;
-- Raising the capacity for knowledge and innovation;
-- Addressing persistent socioeconomic inequalities;
-- Improving the standard and sustainability of quality of life; and
-- Strengthening institutional implementation and capacity.

Where Does the Money Go?

¶7. Practically all sectors will receive more government support because of the increased development expenditure allocation ($12 billion) for 2007. Education and training receive the largest share: $2.1 billion or 17.8% of development expenditure. Transport receives $1.97 billion or 16.4%, security $1.8 billion or 15.3%, trade and industry $1.4 billion or 11.5% and agriculture $1.1 billion or 9.3%.

¶8. The budget allocates RM 27.5 billion ($7.4 billion) to the construction sector for roads, public housing and other

infrastructure. In particular, the Klang Valley area that includes Kuala Lumpur will receive RM10 billion ($2.7 billion) for new light railway links. This injection of funds is expected to revive the politically-connected construction industry, which experienced two years of contraction in 2004-05 and is projected to increase only 0.3% in 2006.

More Goodies for Favored Parties

¶9. Business was pleased by an unexpected cut in corporate tax rates from 28% to 27% in 2007 and 26% in 2008. The government clearly was concerned to bring Malaysia's tax rates closer to regional competitors Hong Kong (17.5%), Singapore (corporate tax 20% and VAT 5%) and Taiwan (corporate tax 25% and VAT 5%). Following widespread protest by businesses, who wanted more time to prepare, the government delayed the planned introduction of a VAT in 2007 until possibly 2009. To further promote Islamic financial services, the budget allows full tax exemption for 10 years for income derived from Islamic banking and takaful businesses conducted in international currencies. Currently, the majority of Islamic banking and takaful businesses are transacted in ringgit. Foreigners are exempted from paying tax for profit and interest income derived from Islamic financial institutions. In addition, the government lowered the withholding tax for returns from Real Estate Investment Trusts (REIT) from 28% to 15% for individuals and 20% for institutions for 5 years. REITs also are exempted from income tax payment if they distribute 90% of their earnings to investors. (Comment: REITs are relatively new in Malaysia with only five REITS, including one Islamic REIT. The government is fostering the development of more REITs, especially those that comply with Shariah principles, to attract more Middle Eastern investors.)

¶10. The government specifically allocated $57 million to support the development of biotechnology. The government also plans to provide venture capital for new technology-intensive agriculture projects, and integrated agriculture and livestock projects. There also are targeted expenditures to support information and communications technologies, research and development, and small and medium sized enterprises (SMEs). Individuals will now be able to claim tax relief of RM3000 ($811) every three years for the purchase

of a personal computer, improving on the current tax rebate of RM500 ($135) every five years. The government has been proclaiming 2007 as "Visit Malaysia Year," and to achieve its target of 20.1 million tourists it is providing more tax breaks for tour operators and for employers who provide sponsored local trips to their employees.

¶11. Civil servants were not left empty handed. Government employees will get a bonus of one to two months' wages and lower income employees will also receive an increase in their benefits allowances. Government employees also will be able to seek a 20% increase in housing loans from the government. Government retirees will receive a one time payment of RM200 ($54) or RM400 ($108) depending on their pension. For students from poor families attending government schools, the government will increase the monthly allowance from RM30 to RM50 for primary school children and RM50 to RM70 for secondary school students.

The Only Pain: Higher Sin Taxes

¶12. The government increased the excise duties on tobacco products by 7% to 8% on September 1, raising the duty by one Malaysian cent per cigarette. This is low compared to previous hikes, but comes on top of four consecutive years of increases. Likewise, the government raised the excise duty for liquor with more than 40% alcohol content by RM5 ($1.35) per liter. Beer drinkers were relieved that the duty on their beverage of choice remained unchanged.

Let the Good Times Roll - For Now

¶13. Comment: Thanks to the oil price windfall, PM Abdullah has been able to shift from his previously tight fiscal policy to generous development spending and moderate growth in other expenditures, while still keeping the deficit under control. However, there are clouds on the horizon that could rain on the party: 1) oil prices could stay below $70 a barrel (they already are trending downward from that peak); and 2) the increased development funds may not have the long-term impact the government desires if they are not spent wisely. If the global economy also starts to slow, even government economists may start reaching for their umbrellas.

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